

For many emerging markets, one of the most striking structural changes in their financial systems during the 1990s has been the growing presence of foreign-owned financial institutions, especially in the banking system. In Central Europe, for example, the proportion of total bank assets controlled by foreign-owned banks rose from 8 percent in 1994 to 56 percent in 1999. In some major Latin American countries, almost one-half of total bank assets are controlled by foreign institutions. This greater foreign participation raises a number of important analytical and policy issues. These include the following:

- What considerations led the authorities to open their financial systems to foreign competition?
- What types of activities have foreign institutions typically found profitable to undertake and what impact has foreign entry had on the profitability and efficiency of both domestic and foreign banks and the financial system's response to large domestic and external shocks?
- What key supervisory and regulatory issues arise as a result of greater foreign participation in the domestic financial system?
- What effects do foreign bank entry and the associated introduction of new financial products and instruments have on the level of systemic risks in the domestic financial system?

To analyze these issues, the rest of this chapter is divided into four sections. The first section examines the extent of the increase in foreign participation in some key emerging market banking systems during the 1990s. The second section considers the factors that have stimulated global financial institutions to expand toward emerging markets as well as the factors that have influenced the authorities' decisions to open their domestic banking systems to greater foreign participation. In addition, there is a discussion of the institutional arrangements that foreign

banks have used to enter various markets. The fourth section reviews both the theoretical arguments and the available empirical evidence about the effects of foreign bank entry on both the efficiency and stability of the domestic banking system. Particular attention is given to examining how the lending and deposit-taking activities of domestic and foreign banks respond to large domestic and external shocks and the degree to which foreign banks have been supported by parents during a crisis or when they get into difficulty. The final section addresses some of the policy issues raised by an increased presence of foreign banks in the domestic banking system, including the need to develop effective cross-border prudential supervisory and regulatory policies for large complex banking organizations and the new instruments and derivative products they introduce, the degree of parental support that is likely to be offered to local establishments during periods of difficulty, the banking concentration issues that can arise, and the effects of foreign bank entry on the level of systemic risk in the banking system.

The evidence to date on the effects of foreign bank entry suggests that the competitive pressures created by such entry lead to improvements in banking system efficiency, but it is still unclear whether a greater foreign bank presence contributes to a more stable banking system and a less volatile supply of credit. Nonetheless, foreign bank entry will be more likely to contribute to a more stable banking system if the parent bank has a strong financial position and is committed to a medium-term strategy of strengthening its position in the local market. Effective cross-border prudential supervision of both the parent and its local entities can also enhance financial system stability and will require the continuous sharing of information between home and host country supervisors and the development of the ability of local supervisors to analyze

Table 6.1. Foreign Bank Ownership in Selected Emerging Markets¹

	Total Assets December 1994	Foreign Control ² December 1994	Total Assets ³ December 1999	Foreign Participation December 1999	Foreign Control ² December 1999	Foreign Control ⁴ December 1999
	<i>(In billions of U.S. dollars)</i>	<i>(In percent)</i>	<i>(In billions of U.S. dollars)</i>	<i>(In percent)</i>	<i>(In percent)</i>	<i>(In percent)</i>
Central Europe						
Czech Republic	46.6	5.8	63.4	47.3	49.3	50.7
Hungary	26.8	19.8	32.6	59.5	56.6	80.4
Poland	39.4	2.1	91.1	36.3	52.8	52.8
Total	112.8	7.8	187.1	44.0	52.3	56.9
Turkey	52.0	2.7	156.2	1.6	1.7	1.7
Latin America						
Argentina	73.2	17.9	157.0	41.7	48.6	48.6
Brazil	487.0	8.4	732.3	18.2	16.8	17.7
Chile	41.4	16.3	112.3	48.4	53.6	53.6
Colombia	28.3	6.2	45.3	16.2	17.8	17.8
Mexico	210.2	1.0	204.5	18.6	18.8	18.8
Peru	12.3	6.7	26.3	33.2	33.4	33.4
Venezuela	16.3	0.3	24.7	34.7	41.9	43.9
Total	868.6	7.5	1302.4	24.2	25.0	25.5
Total excluding Brazil and Mexico	171.4	13.1	365.6	39.5	44.8	44.9
Asia						
Korea	638.0	0.8	642.4	11.2	4.3	16.2
Malaysia	149.7	6.8	220.6	14.4	11.5	11.5
Thailand	192.8	0.5	198.8	6.0	5.6	5.6
Total	980.5	1.6	1061.8	10.9	6.0	13.2

Source: IMF staff estimates based on data from Fitch IBCA's BankScope Database.

¹ Ownership data reflect changes up to December 1999 while balance sheet data are the most recent available in Fitch IBCA's BankScope.

² Ratio of assets of banks where foreigners own more than 50 percent of total equity to total bank assets.

³ For Central Europe and Asia available balance sheet data are in most cases for December 1998.

⁴ Same as footnote 2 but at 40 percent level.

the implications of the new products introduced by foreign banks.

Increase in Foreign Bank Entry to Emerging Markets

The extent of foreign ownership in emerging market banking systems has increased dramatically during the second half of the 1990s and market participants expect further increases. However, there have been widely divergent trends across different regions, with Central

Europe showing much larger increases than Asia (Table 6.1). The increased activities of foreign banks in emerging markets can be measured either in terms of foreign bank participation in domestic banking markets or in terms of how effectively foreign banks control banking activities. For example, while foreign banks might participate in a number of joint ventures as minority shareholders, the overall operations of the banks might be controlled by the local majority shareholders. Using publicly available balance sheet and ownership data,¹ Table 6.1 presents meas-

¹The data are from Fitch IBCA's Bank Scope data base. There are three major advantages of using this data base. First, coverage is comprehensive, with banks included accounting for about 90 percent of the assets of banks in each country; second, the agency makes an effort to adjust individual bank accounts for differences in reporting and accounting standards, and puts the accounts into a standardized global format (see Claessens, Demirgüç-Kunt, and Huizinga, 1999); and, third, it allows for the use of individual bank data (usually unavailable from official sources) to analyze several definitions of ownership and performance ratios for domestic and foreign banks. The main drawback is that the activities of some foreign branches are not captured, which leads to an underestimation of the level of foreign participation, especially in countries where entry through branches is the main modality—such as the Asian countries. Whenever such underestimation is important, this is indicated in the text.

ures of both participation and control by foreign banks in different regions. Foreign participation is measured as the ratio of the sum across all banks of the assets of each bank multiplied by the percentage of equity held by foreigners to total bank assets. In contrast, the table presents two measures of the extent of bank assets under effective foreign control since corporate control may not be directly and exclusively related to the proportion of a bank's equity held by a particular owner.² While holding more than 50 percent of total equity typically ensures effective control of a bank, a number of analysts have argued that hostile takeovers are unlikely to occur when the existing owners hold more than 40 percent of bank equity.³ The extent of foreign control is thus measured by the ratio of the sum of the total assets of those banks where foreigners own more than either 40 or 50 percent of total equity to total bank assets.⁴

Central Europe

Foreign participation in Central Europe increased considerably in the second half of the 1990s, and by the end of the decade the share of banking assets under foreign control had reached more than 50 percent (Table 6.1).⁵ Following the banking crises of the first half of the decade, the privatization of state-owned banks increased foreign participation substantially. Initially, most of the sales were of medium-sized banks, but more recently the large state-owned saving and foreign trade banks have been sold (or are in the process of being sold). Hungary took the lead in the privatization process, and by end-1999 foreign participation in the banking system was about 60 percent of total assets. Poland's privatization process, accel-

erated over the past two years and, with the sale of Bank Pekao in mid-1999, the share of bank assets under foreign control rose to 53 percent. The Czech Republic began to privatize its state-owned banks in 1998, and by early 2000 three of the four large state-owned banks had been sold. As a result, foreign institutions controlled 46 percent of total banking assets by end-1999, and that share increased to more than 60 percent with the sale of the second-largest bank early this year.

Latin America

Although foreign banks have been present in Latin America for many decades, there has been a quantitative jump in the degree of foreign participation in the second half of the 1990s with the acquisition program initiated by the leading Spanish financial institutions. Indeed, the presence of foreign banks is important not just because of the size of their market share but also because leading institutions in almost every country are controlled by foreign institutions.

Foreign banks had a relatively large presence in Argentina and Chile by end-1994 (see Table 6.1), but the share of assets under foreign control increased to the 50 percent level following a series of mergers and acquisitions in 1996–97. In the larger markets of Brazil and Mexico, foreign participation has traditionally been lower, but assets under foreign control had reached 18 percent by end-1999. However, the sale of the third-largest Mexican bank in May 2000 and of the second-largest in June 2000 has brought the share of assets under foreign control to about 40 percent (see Annex II). Brazil is the only banking market in Latin America where foreigners are unlikely to have a dominant position, owing

²See, for instance, Hellwig (1999) and Crama and others (1999).

³See García Canera and Burbridge (1999).

⁴The measures of foreign participation and foreign control would be identical if all banks were fully (i.e., 100 percent) owned by either domestic or foreign investors. In some instances, our measures of foreign control can exceed the measure of foreign participation. This can occur because all the assets of a "controlled" bank are regarded as foreign-owned, whereas our participation measure counts as foreign-owned assets only the product of banks' assets and the proportion of equity held by foreigners.

⁵A more detailed description of major trends in foreign ownership for several emerging markets is contained in Annex II.

to a large share of bank assets under government control and the existence of three large, well-capitalized, and well-managed private banks. The entry of two large European banks in 1997–98 nevertheless changed the banking landscape and increased competition, and further foreign acquisitions are possible with the forthcoming privatization of several state banks.

Asia

Foreign banks have played a smaller role in most Asian financial systems than in Central Europe or Latin America, reflecting in part official policies that have limited entry, especially into local retail banking markets. The restrictions on foreign bank entry have typically involved limitations on both the number of foreign banks that could enter the market and the number of branches they could establish within the market. After the crisis, several countries have liberalized entry norms for foreign banks, with the exception of Malaysia. However, foreign bank participation in Malaysia is 23 percent of total commercial bank assets, one of the highest in the region.⁶

The speed and scope of the foreign influx in Korea and Thailand has been lower than originally expected by most analysts.⁷ The sale of Korea First Bank to Newbridge Capital accounts for the increase in foreign control in Korea (see Table 6.1), while the increase in foreign participation also captures the increasing (minority) stakes in several banks.⁸ Foreign bank participation in Thailand has been traditionally low, though the involvement of foreign banks has

been larger than the figures in Table 6.1 suggest, owing to the banks operating through the Bangkok International Bank Facility (BIBF).⁹ After the crisis, four banks were sold to foreign institutions, increasing the share of assets under foreign control from 0.5 percent at end-1994 to 4.5 percent at end-1999 (Table 6.1). However, the share of assets under foreign control could rise with the privatization of the other intervened banks.

Factors Increasing the Role of Foreign Banks in Emerging Markets

Globalization of Financial Services

The increase in foreign ownership of banks in emerging markets is one facet of the ongoing consolidation of banking systems in both mature and emerging markets. As noted by Folkerts-Landau and Chadha (1999) and Vansetti, Guarco, and Bauer (2000), the globalization of the financial services industry has resulted in banks facing competition from a variety of non-bank sources of credit and financial services (particularly securities markets) that has put pressure on interest rate margins and profits, which in turn has eroded the “franchise” value of banks.¹⁰ Moreover, banking is inherently an information, communication, and computation intensive industry, and the cost of undertaking these activities both domestically and across borders has declined dramatically in recent decades. These developments have created economies of scale (especially in terms of transactions related to back-office operations) and scope (particularly

⁶This figure refers to commercial banks only; the figures in Table 6.1 are lower because they include finance companies and merchant banks that are majority-owned by Malaysian interests.

⁷The increase in foreign participation since the beginning of the financial crisis has been around 9 percent of total assets in both Korea and Thailand (including the recent sale of Bangkok Metropolitan Bank). See Annex II for further details.

⁸Foreign banks have been allowed to open branches in Korea since 1967. There were 52 foreign bank branches in September 1997, and their market share was just 2 percent of total financial system assets (see Baliño and Ubide, 1999).

⁹The BIBF scheme was established in 1993 to develop Bangkok as a regional financial center. In addition to offshore lending, the BIBF also allowed foreign banks to lend locally in foreign currencies, and the rapid growth of this lending in 1994–97 contributed to the financial crisis (see IMF, 1998a). Despite the fact that this type of lending has been substantially curtailed since 1998, the numbers in Table 6.1 appear to underestimate foreign bank participation in Thailand.

¹⁰The franchise value of a banking license reflects the discounted value of the net profits that bank would be expected to earn over time.

with regard to the development of OTC derivatives products, see Chapter IV). To capture these economies of scale and scope, banks have competed intensively to capture market share. The intense competitive pressures that have arisen during this process have resulted in a decline in the profitability of traditional banking activities and have driven the major banks to diversify geographically and also to enter into other financial activities.¹¹ In particular, a more liberal regulatory environment has made it possible to exploit complementarities among areas of banking, securities and risk management, which has led to the emergence of new products (particularly OTC derivatives instruments) and improvements in the distribution of these new financial products and services.¹² For instance, telephone and electronic banking have been widely used by foreign banks to gain market penetration in European markets and more recently in emerging markets, especially in Asia (Box 6.1).

The intense competitive pressures faced by large international and regional banks in mature markets have provided these banks with strong incentives to use the comparative advantages derived from the development of new financial products and services to enter both offshore and local emerging markets.¹³ Only a few financial institutions have the management capabilities to conduct global commercial banking operations, but several others are establishing a significant regional presence.¹⁴ The need to overcome the disadvantage of local knowledge makes location and cultural factors (including language) important determinants of the willingness to enter emerging markets. This has led to the emergence of “regional evolvers”—that is, banks that focus their activities on a particular region, such

as the Spanish banks in Latin America, the Austrian, Belgian, Dutch, and German banks in Central Europe, and, to a lesser extent, the Australian and Japanese banks in Asia.¹⁵ The large Spanish banks redefined their international expansion strategy after the Asian crisis, pulling out of that region and focusing on becoming large regional banks in Latin America and Western Europe (Box 6.3).

Removal of Barriers to Foreign Entry

Although there are strong incentives for foreign banks to expand abroad, they have until recently faced substantial barriers to entry in most emerging markets. While most countries establish licensing requirements applicable to both domestically and foreign-owned banks, foreign banks have typically faced stricter limits on the availability of banking licenses, restrictions on the number of branches, controls on permissible activities, and restrictions on the extent of foreign ownership of individual banks and/or total bank assets.¹⁶ For instance, in many Asian countries up until the recent crisis, foreign banks were allowed only a single branch and foreign bank licenses had been frozen for an extended period. Even in the financial centers of Singapore and Hong Kong SAR, where foreigners participate actively in wholesale banking and capital market activities, foreign retail banking has been restricted.

A greater openness to foreign trade and investment combined with the need to build up more efficient and stable financial systems in the aftermath of crises have been major catalysts for the removal of barriers to entry of foreign institutions. As noted by Eichengreen and Mussa

¹¹See Canals (1997).

¹²Typical complementarities involve trade credit and the provision of hedging products, or the cross-selling of deposits, mutual funds, and insurance.

¹³Williams (1997) surveys theories and evidence on multinational banking.

¹⁴Foreign banks have adopted a variety of institutional arrangements to enter emerging markets, including representative offices, branches, subsidiaries, and joint ventures (see Box 6.2).

¹⁵A couple of Singaporean banks also have regional ambitions, especially Development Bank of Singapore, which has made acquisitions in Thailand, Hong Kong SAR, and the Philippines.

¹⁶While we focus on legal and regulatory barriers to entry, fixed costs and information asymmetries could also restrict entry into foreign markets (see Vives, 1991, and Dell’Ariccia, 1997).

Box 6.1. The Internet and Cross-Border Banking

The Internet has become a key structural force—along with disintermediation and deregulation—currently reshaping the banking industry. The primary impact of the Internet in the financial services industry is to increase competition, through the lowering of barriers to entry in distribution and the increased transparency in the pricing of financial products. The Internet will lead more banks to expand their cross-border activities. More important, it will allow well-established banks with already developed franchises in emerging markets to expand their market shares. The increased competition will put further pressure on those local banks that fail to adopt similar Internet strategies, especially those burdened by high cost structures and bad loan portfolios. Local bankers in emerging markets regard Internet banking as the greatest single threat to the franchise value of their branch network systems; and, although these markets are currently behind the United States and Europe in terms of developing online banking and attracting large numbers of customers, market participants see this as something that will change in a short period of time.

Industry Changes

There are basically four Internet banking business models and, although it is difficult to envision which ones will be the most successful, some are more appropriate for cross-border ventures than others. The four basic models are as follows:¹

- *The Integrated Approach:* complements the existing branch and telephone network of an established bank by offering existing financial products via the Internet;
- *The Stand-Alone Internet Bank:* a financial institution establishes a separately branded, legally independent, online bank;
- *The Virtual Bank:* similar to the stand-alone Internet bank, but founded and owned by a nonbank institution;
- *The Aggregator or Virtual Financial Supermarket:* a bank that offers its products online but also

sells financial products developed by other financial institutions.

The stand-alone Internet bank is particularly well-suited for cross-border ventures, as it has the flexibility of following strategies (in terms of products, pricing or customers) that are different from the parent company. In particular, the new technology offers a low-risk approach to cross-border ventures, as the capital outlay is small, operating expenses are minimal, and the ability to “cherry pick” is enhanced. In many cases, banks use the integrated model for their domestic operations and the stand-alone for overseas ventures. Examples of these cross-border initiatives are abundant in the mature markets, but they are extending rapidly to the emerging markets. One example is that of Uno-e, a joint venture between BBVA and Terra Networks of Spain. Uno-e recently merged with First-e—a virtual bank based in Ireland—creating one of the most globally diverse Internet banks, which will keep the First-e brand for the Northern European region while the Uno-e brand will be used for the expansion into the Iberian Peninsula and the emerging markets of Latin America. Furthermore, Singapore’s Overseas United Bank has recently established a joint venture with First-e to create the first Asian stand-alone Internet bank and complete the global reach of First-e.²

Virtual banks are stand-alone Internet banks typically set up by insurance, retail or information technology companies. A good example is Egg, the Internet bank created by Prudential, the United Kingdom’s largest life insurer. In an attempt to take a lead in the rapidly extending electronic banking industry in the region, Prudential is studying the possibility of producing an Asian version of Egg. However, the project is likely to focus initially on sales of investment and life insurance products, as it would

²First-e group will provide the human and technical capital, while Overseas United Bank will provide the back-office processing support; central bank regulations on capital, size, and scope are pending.

¹See Fitch IBCA (2000).

Box 6.1 (concluded)

take time for Prudential to obtain banking licenses in the region.

The new technology is increasing competitive pressures in most emerging markets, but rating agencies and analysts see many major local players as well placed due to their strong customer bases, respected brands, and ongoing Internet plans. However, they also see a widening gap between progressive incumbent players

and weaker ones that fail to develop a successful defense strategy. In Latin America, for instance, the three large Brazilian banks are the most advanced in the region and are gradually adopting the new distribution channels. Similarly, the largest banks in the financial centers of Hong Kong SAR and Singapore, and the most dynamic ones in the Asian crisis countries, have made their initial e-banking offerings.

(1998), many emerging markets have been reducing barriers to trade in financial services since the early 1990s, and allowing for the entry of foreign financial institutions has been just one facet of this more general liberalization.

Nonetheless, by the mid-1990s, only a modest amount of foreign bank entry had occurred (Table 6.1). In part, this limited foreign entry reflected concerns about the potential effects of foreign bank entry and the political resistance to such entry by the domestic banking industry.

While significant changes in the restrictions on foreign bank entry have at times been motivated by a desire to improve the levels of competition and efficiency in the banking system, they have often been triggered by the need to help reduce the costs of restructuring and recapitalizing banks following a major crisis, as well as a desire to build an institutional structure in the banking system that is more robust to future domestic and external shocks.¹⁷ The experience with banking system instability in many emerging markets since the 1970s (Lindgren, García, and Saal, 1996) has demonstrated the need to make domestic banking systems more robust to large external and domestic shocks. While the authorities in most emerging markets have moved to strengthen prudential supervision of their banking system, there has been a recognition that relatively small banks holding interna-

tionally undiversified portfolios remain a source of vulnerability in the face of large shocks. To improve on this situation and often to help reduce the costs associated with recapitalizing and restructuring banks in a postcrisis period, the authorities in a growing number of emerging markets have begun to open their banking systems to foreign entry in an effort to improve banking system efficiency and to have banks that are part of organizations that hold globally diversified portfolios. However, some analysts have noted that, while internationalization of a banking system does yield institutions with more diversified portfolios, this may not necessarily yield a more stable source of credit for domestic borrowers, for two reasons. To the extent that foreign bank entry is accompanied by a reduction in barriers to capital outflows, banks may use funds raised in the domestic market to undertake external lending. As a result, domestic borrowers might not have the same degree of access to domestic savings. Moreover, foreign banks can at times be expected to shift funds abruptly from one market to another as the perceived risk-adjusted returns in different markets change.

The relative importance of efficiency and stability considerations has differed across regions. In the transition economies of Central Europe, for instance, the need to build up institutions rather quickly—in an environment where there

¹⁷The emergence of regional financial sector difficulties in the United States during the 1980s has also been a driving force behind the movement toward the removal of interstate banking restrictions (Gunther, 1994).

Box 6.2. Modalities of Foreign Bank Entry

When foreign banks enter emerging markets, they adopt a variety of institutional structures (including representative offices, branches, subsidiaries, and joint ventures) and these different modalities tend to entail different degrees of commitment to service host country markets. For example, some banks have established foreign operations to service the needs of their corporate customers that have undertaken activities abroad, and these banks often initially establish representative offices. Representative offices are designed to help the parent bank and its client (usually a nonfinancial multinational enterprise) deal with the variety of commercial and financial business that relate to the foreign market, and they represent a minimum level of commitment to the foreign country. They generally handle trade credit operations but also allow the parent bank to engage in investment banking activities, such as arranging international private debt and equity placements between borrowers in the host (emerging) country and lenders in the source country. Representative offices do not handle retail banking operations and, in some countries, they are restricted to non-income-generating activities.

A foreign branch is an overseas office of a bank incorporated in a foreign country and constitutes a higher level of commitment than a representative office. Foreign bank branches are typically involved in the wholesale deposit and money markets, and they also arrange loans for both local and foreign agents and deal in the capital markets. The establishment of a branch is more costly than that of a representative office, but the higher cost might be justified if the foreign bank wishes to be a player in local money and capital markets in order to take advantage of the knowledge and expertise it acquired in the mature capital markets. Indeed, in a study of the structure of foreign banking in the United States, Heinkel and Levy (1992) found that the number of foreign bank branches depends significantly on the size of the capital market where the parent operates.

Bank subsidiaries are often used to enter retail banking markets. These institutions are sep-

arately incorporated from the parent bank, whose financial commitment to the subsidiary consists of the capital invested. In many countries, the restructuring of banks and subsequent privatization after a crisis has provided incentives to enter markets through the acquisition of local banks rather than the more costly establishment of a *de novo* (greenfield) operation. This modality has been used recently by European banks (mostly Austrian, Belgian, Dutch, and German) in Central Europe and Spanish banks in Latin America. The latter have typically purchased controlling stakes in relatively large domestic banks, and have kept even their wholly owned acquisitions as local subsidiaries rather than as branches of the parent.¹ Major international banks that originally created networks of branches around the world—such as Citibank, HSBC, ABN-Amro, ING, and Deutsche Bank—have gradually moved toward a strategy of making selective acquisitions in key emerging markets and have kept them as subsidiaries. Some of them (e.g., ABN Amro) are following a “pillar” concept in expansions—that is, making opportunistic acquisitions in interesting emerging markets and trying to stay among the top three foreign banks in terms of market share.

The establishment of alliances or joint ventures with local partners is the preferred modality of foreign expansion when the foreign bank lacks, but wishes to acquire, specific knowledge about the local market conditions. This usually involves taking minority stakes in local entities, and the level of involvement in the management of the local bank by the foreign entity is normally low (the foreign entity usually has one or more members on the board of the local bank and perhaps a few members in operating committees). Experience suggests that, in many cases, the acquisition of a minority stake is the first step toward the next category of owning a fully controlled subsidiary—in many cases, acquiring a controlling stake is a consequence of the financial difficulties of the local entity, as

¹See Guillén and Tschoegel (1999).

Box 6.2 (concluded)

shown by the case of HSBC in Bamerindus or BBV in Probusa.²

A particular form of joint venture that has become more widely used recently is that between banks and insurance companies (*bancassurance*) that aims at using the distribution capacity of the local banks to sell insurance products. Similar joint ventures have been arranged with asset management companies, in countries that allow universal banking. In many cases, such joint ventures are part of the strategy followed

by local large banks in order to remain independent. For instance, Banamex (the largest Mexican bank) has developed a strategic partnership with AEGON for the distribution of insurance products, with MCI for telephone and Internet banking and with Commerce One for e-commerce. In another typical example, ING has a *bancassurance* deal with Mexico's Bitel and has recently acquired the banks' pension fund, Mexico's fastest-growing one. In April 2000, Germany's Allianz Group took a 12.5 percent stake in a leading Korean bank (Hana Bank) as part of a broader agreement to develop asset management and *bancassurance* in Korea.

²See García Cantera and others (1997).

were short histories of operation under market rules—combined with the cost of bank recapitalization programs, convinced the authorities that privatization to strategic foreign investors would be the best solution to their banking problems.¹⁸ Similarly, the scale of banking problems in the mid-1990s in Mexico¹⁹ and Venezuela, and to a lesser extent also in Brazil, created incentives to allow for more foreign bank entry to rebuild capital and bring in new financial expertise. In countries that had already allowed a significant foreign presence, such as Argentina and Chile, the financial turbulence of the second half of the 1990s contributed to a process of mergers and acquisitions that substantially increased foreign participation in the local banking market.

To date, the increase in foreign ownership in Asia has been smaller than in Central Europe and Latin America, but market participants expect this situation to change soon. Analysts note a number of reasons for the relatively slow increase in foreign participation. First, there are

still official concerns that foreign banks will “cut and run” during a major crisis and are therefore not a stable source of funding for the local market. Second, family ownership and management structure have been perceived as an important obstacle to the resolution of the financial crises, in part due to an unwillingness to cede control to foreign investors.²⁰ Third, foreign bank entry was slowed by the fact that most international banks from Europe and the United States had to deal with their own balance sheet problems after the Russian crisis and the near-failure of LTCM, while the Japanese banks have been forced to focus on domestic problems.²¹ Fourth, the level of bank intermediation is much higher than in Latin America; hence, prospects for growth are much less—and lots of restructuring remains to be done. Finally, the franchise value of banks may be declining because corporate borrowers are turning to capital markets for funding and the prospects of Internet banking have reduced the value of having a large branch network (see

¹⁸More recently, the need to comply with the requirements of membership in the Organization for Economic Cooperation and Development (OECD) and the prospects of European Union accession have provided a further impetus to the removal of barriers to entry in the major transition economies.

¹⁹In the case of Mexico, the crisis accelerated a process of opening up the financial services industry in the context of the North American Free Trade Agreement (NAFTA).

²⁰See Fitch IBCA (1999a).

²¹See Irving and Kumar (1999).

Box 6.3. BBVA and BSCH: The Expansion of Spanish Banks to Latin America

Since the mid-1990s, the two largest Spanish banks, Banco Santander Central Hispano (BSCH) and Banco Bilbao Vizcaya Argentaria (BBVA), have become the largest foreign institutions in retail banking in Latin America.¹ Together they have spent about US\$13 billion to purchase control of some 30 major banks in more than 10 countries, accounting for some US\$126 billion in assets (almost 10 percent of the region's banking assets—or about 7½ percent of regional GDP). In addition, they have expanded into the pension fund business, where they also control around 45 percent of the region's industry.

Internationalization Strategies

Both banks had a small presence in the region in the 1970s and 1980s, but they started their current cross-border expansion in the early 1990s.² Both institutions bought relatively large stakes in large banks, aiming at competing in the lower- and middle-income mass retail markets. While BSCH has generally bought majority stakes in its acquisitions and has put its brand name on them, BBVA tended to buy minority stakes—provided the investment was large enough to render management control—and kept the local bank brand name in most instances. More recently, both have continued to acquire remaining minority holdings in their own subsidiaries to consolidate control of their operations.³

¹In January 1999, Banco Santander and Banco Central Hispano merged to form BSCH, the largest Spanish bank by end-1999 assets; in January 2000, Banco Bilbao Vizcaya and Argentaria merged to form BBVA, the second largest bank.

²See Guillén and Tschoegel (1999) for a thorough analysis of the Spanish banks' expansion into Latin America.

³In late 1999, BSCH began its America project, which basically explores the possibility of creating a holding company that will comprise all the financial investments of the group in Latin America, including banks, pension funds, asset management companies, insurance, leasing, and some investment banking activities. The company is expected to be formed by end-2000 and may subsequently de-list its subsidiaries from local equity markets. The process of de-listing the subsidiaries from foreign institutions is contributing to the reduced liquidity of local stock markets in Latin America (see Chapter III).

Banks in Latin America

(Assets in billions of U.S. dollars; end-1999)

BSCH (Spain)	85.4
Bradesco (Brazil)	44.6
BBVA (Spain) ¹	40.6
Banamex (Mexico)	30.6
Bank Boston (United States)	30.0

Source: BSCH.

¹BBVA and Bancomer = \$68.1.

Analysts have characterized the expansion of the Spanish banks as a case of “oligopolistic reaction,” one where a firm matches the location choices of a rival in a pattern of move-countermove or action-reaction. The pattern may begin with one firm (BSCH) making the first move and the other (BBVA) following the leader, but in this case leapfrogs of leadership have occurred so that at some point one can no longer unambiguously describe one firm or the other as the overall leader. Following a series of acquisitions that have put them among the three largest private banks in Latin America (see table), the banks have now focused their rivalry in the largest (and least foreign-controlled) markets of Brazil and Mexico (see Annex II).⁴ Moreover, in early May 2000, BBVA and BSCH announced capital raising programs representing around 7 percent of existing capital to finance acquisitions in Latin America and the euro area and to finance e-business ventures.

The Spanish banks have already transferred significant financial expertise to Latin America, but their establishment of a regional banking network is still far from complete. Some obvious parent contributions have been the introduction of new products—such as lottery-linked deposit accounts and fast-approval mortgages—information and risk management systems. However, although the banks are already working in the integration of their common software and hardware platforms, analysts believe that it will

⁴BSCH and BBVA have become the two largest private banks in the region following the recent merger of BBVA-Mexico with Bancomer.

Box 6.3 (concluded)

still take some time before a full integration into a regional network becomes operative. Moreover, there are limits to the activities that local banks can share with their parent, and differences in local banking regulations also limit the development of regional networks.⁵

Universal Banking

Both banks have followed the universal banking model and have also expanded into pension fund, asset management, insurance, and investment banking activities. In particular, the rapid growth of the private pension fund industry in Latin America (that currently manages about US\$140 billion in assets) has provided significant opportunities for banks in the region. BBVA has become the region's largest pension-fund manager with a 31 percent share of the regional market. After the merger with Argentaria at end-1999, BBVA's market shares were 100

⁵See García Cantera and Burbridge (1999).

percent in Bolivia and Ecuador, 43 percent in Colombia, 33 percent in Chile, 29 percent in Argentina, 24 percent in Peru, and 10 percent in Mexico.⁶ BBVA is also expanding into the insurance business, to exploit not only opportunities to cross-sell insurance products through bank branches, but also potential synergies between its pension fund and insurance businesses, as these practices are not restricted in many Latin American countries. BSCH has also a substantial presence in the pension fund industry, but contrary to BBVA has been more active in the investment banking area. In the mid-1990s, Banco Santander had decided to become one of the three major investment banks doing business in Latin America from New York, but the strategy proved too expensive and BSCH is now focusing more on its local presence in the major countries of the region.

⁶Antitrust laws will require BBVA to sell one of the two pension fund managers in Argentina and Bolivia.

Box 6.1). However, market participants argue this situation will change sharply in the next few years as a result of greater openness to foreign bank entry (reflecting the need to recapitalize the banking systems in countries such as Indonesia, Korea, and Thailand and the desire to make financial centers such as Hong Kong SAR and Singapore more competitive and efficient) and the intense pressures for consolidation in local retail banking markets.

Effects of Foreign Bank Entry

The sharp rise in the level of foreign bank participation in many emerging markets is clear evidence that the authorities in these countries have concluded that foreign bank entry will have an overall positive effect on the efficiency and

stability of the banking system. Nonetheless, the effects of foreign bank entry on the efficiency and stability of the local banking systems have been much debated in many countries. This section examines the nature of the arguments concerning the likely effects of foreign bank entry, as well as the available empirical evidence.

Arguments Concerning Banking Efficiency and Stability

Allowing foreign banks to enter is typically viewed as having the most beneficial effects when such entry occurs in the context of a more general liberalization of trade and production of financial services.²² It is argued that a general liberalization of trade in financial services induces countries to produce and exchange finan-

²²The arguments concerning the effects of foreign bank entry are discussed in Berger and others (2000); Claessens, Demirgüç-Kunt, and Huizinga (1999); Claessens and Glaessner (1999); Barajas, Steiner, and Salazar (1999); Clarke and others (1999); Denizer (1999); Kiraly and others (1999); Laeven (1999); and Tamirisa and others (2000).

cial services on the basis of comparative advantage. Allowing foreign bank entry as part of this liberalization process is seen as improving both the efficiency and stability of the banking system. It is argued that foreign banks will help improve the quality, pricing, and availability of financial services, both directly as providers of such enhanced services and indirectly through competition with domestic banks, which will encourage the latter to introduce similar improvements. These new financial products can provide better opportunities for portfolio diversification and intertemporal trade. A transfer of technology occurs if the authorities allow high-quality international banks with solid reputations to enter and permit the immigration of skilled banking personnel. Since these banks will also hire local bankers with a better knowledge of the local economy, these local bankers will assimilate the practices and technology of the international banks, which they retain when they move back to domestic banks. In addition, foreign banks are often seen as improving the allocation of credit since they have more sophisticated systems for evaluating and pricing credit risks. Similarly, it is often argued that foreign banks can better assess and price the risks associated with various derivative products because of their experience with the use of these products in international financial markets.

Others see foreign banks as making much less of a contribution to an efficient allocation of credit. One concern is that foreign banks “cherry pick” the most profitable domestic markets and customers, leaving domestic banks to serve the other (more risky) customers and thereby increase the overall riskiness of domestic banks’ portfolios. Under this cherry-picking strategy, foreign banks are viewed as focusing their lending activities on wealthy individuals

and the most creditworthy corporates. In addition, it has been argued that it may be difficult for foreign banks to transfer some of the credit risk evaluation methods used in mature markets. In particular, while some analysts have claimed that foreign banks have a comparative advantage in evaluating the credit risks in retail and consumer lending markets because of their use of statistical credit scoring methods, others have noted that the use of such credit scoring methods may face informational constraints in emerging markets.²³ Moreover, reliance on credit scoring methods is seen as reducing lending to small firms, as this type of lending usually requires “soft” information (i.e., information that is not easily quantifiable and is generally obtained through a long-term relationship with the client) as opposed to hard, statistical information.²⁴ As a result, some have argued that this pattern of lending tends to encourage the development of oligopolistic and monopolistic industrial structures, especially in economies with relatively small domestic markets.

It has also been suggested that foreign banks can provide a more stable source of credit and can make the banking system more robust to shocks. This greater stability is said to reflect the fact that the branches and subsidiaries of large international banks can draw on their parent for additional funding and capital when needed. In turn, the parent may be able to provide such funding because it will typically hold a more internationally diversified portfolio than domestic banks, which means that its income stream will be less correlated with purely domestic shocks.²⁵ Moreover, large international banks are likely to have better access to global financial markets than domestic banks.

It has also been argued that the entry of foreign banks can improve the overall stability of

²³See Garber and Weisbrod (1994).

²⁴See Belaisch and others (2000).

²⁵Similar issues have been discussed in the context of the removal of interstate banking restrictions in the United States. The lack of geographical diversification of U.S. banks until the removal of interstate restrictions has been noted as a source of financial instability, in particular when compared with unrestricted Canadian banks (see Williamson, 1989). However, opponents to the removal of such restrictions argued that interstate banks would siphon funds from local areas and deprive local customers of credit (see Jackson and Eisenbeis, 1997, for evidence against this claim).

the domestic banking system. The entry of sound foreign banks is seen as implicitly allowing a country to import strong prudential supervision for at least a portion of the financial system. This would be especially true for foreign branches of international banks since they are supervised on a consolidated basis with the parent under the terms of the Basel Concordat. While a local subsidiary of an international bank is technically a stand-alone entity with its own capital, it is argued that the reputational effects of allowing a subsidiary to fail will lead the parent to closely monitor the subsidiary's activities. Moreover, when the subsidiary is part of a holding company or a universal bank, then the subsidiary may also be supervised on a consolidated basis by the parent's supervisory authority. In addition, the presence of foreign banks, which engage in new and more sophisticated activities and provide new products, may lead the domestic supervisory authorities to upgrade the quality and size of their staff in order to better supervise the activities of both domestic and foreign banks. The branches and subsidiaries of major international banks are also likely to have disclosure, accounting, and reporting requirements that are closely aligned with international best practices. To the extent that local banks emulate these practices to be perceived as being as strong as the foreign banks, then the overall quality of information about the state of the banking system would be improved. It has also been suggested that the presence of foreign banks during a crisis can add to the stability of the banking system by allowing domestic residents "to do their capital flight at home." In essence, if domestic residents have doubts about the stability of domestic banks during a crisis period, they can shift their deposits to foreign banks located in the country rather than abroad, which should help stabilize the overall stock of deposits. Finally, some have argued that foreign banks may allow for indirect access to the lender-of-last-resort facilities of the mature markets through their parent.

Others have argued, however, that foreign bank entry can worsen banking system stability.

If domestic banks are relatively inefficient and have weak capital positions, for example, they may either respond to increased foreign competition by undertaking higher-risk activities in an attempt to earn the returns needed to rebuild their capital positions or they will be forced into bankruptcy. Moreover, as already noted, this problem may be intensified if foreign banks tend to "cherry pick" the most creditworthy domestic markets and customers, leaving domestic banks to serve the other (more risky) customers and thereby increase the overall riskiness of domestic banks' portfolios. Experience during the early stages of financial liberalizations (with or without foreign bank entry) in many countries suggests that this is not an unwarranted concern. In many cases, this weakened financial position of domestic banks has reflected the fact that such institutions entered the liberalization period holding loans carrying fixed interest rates (that had been subject to interest rate ceilings in the preliberalization period) and had to compete with other institutions that were free to set higher lending rates and offer higher deposit interest rates. As the profit and capital positions of the disadvantaged institutions deteriorated, some undertook high return but high-risk activities, especially in situations where their deposit liabilities were subject to deposit insurance guarantees.

Apart from the impact of foreign bank entry upon the stability of domestic banks, there have also been concerns about the behavior of foreign banks during crisis periods. Indeed, in Asia one of the most frequently cited reasons for limited foreign bank entry is the perception that foreign banks have "cut and run" during recent crises, especially in the period following the 1997 crisis. While it is evident that cross-border lending to emerging markets has often fallen sharply in the 1990s in postcrisis periods, there is the question of whether foreign banks with a local presence are more likely to maintain their exposures to domestic borrowers than are foreign banks that only engage in cross-border lending. The next section examines some of the evidence on the behavior of local

and cross-border lending during recent crisis periods.

A final concern that is often voiced about the entry of foreign banks is linked to the issue of whether they will be adequately supervised. As noted earlier, it has been argued that the entry of foreign banks is a means of importing strong prudential supervision for at least a portion of the banking system and quite possibly stimulating improvement in the quality of the staff and practices of domestic supervising. In contrast, some observers have argued that the complex cross-border financial transactions undertaken by international banks may be difficult to supervise by either the host or the home country supervisors. They cite the examples of Bank of Credit and Commerce International (BCCI) and Peregrine Investments, which they see as having “fallen between the cracks” in terms of appropriate supervision. As will be discussed in the next section, this issue has received increased attention from supervisory authorities.

Empirical Evidence on Efficiency Effects

This debate over the potential effects of foreign bank entry has led to a number of recent empirical studies of the efficiency and, to a lesser extent, the stability effects of foreign bank entry. One of the striking results of recent studies of the effects of foreign bank entry on banking system efficiency is the differing results for mature and emerging markets. In examining the experience of France, Germany, Spain, the United Kingdom, and the United States, for example, Berger and others (2000) analyzed cost and profit efficiency for both foreign and domestic banks using annual data for 1993–98. In these mature markets, they found that foreign banks were less efficient in terms of either costs or profits, on average, than domestic banks. However, some banking organizations—particularly from the United States—were found to con-

sistently operate at or above the efficiency levels of domestic banks. They argued that this latter result reflected the fact that the home field advantages (arising from their local knowledge and proximity to the local market) of domestic banks were offset by the global advantages (which reflect such factors as superior risk management practices, superior product mix, or more diversified portfolios) enjoyed by some foreign banks.

In contrast, virtually all empirical studies that have included either mixed samples of mature and emerging markets or have focused on emerging markets have concluded that foreign banks have been more efficient in terms of both costs and profits. For example, Claessens, Demirgüç-Kunt, and Huizinga (1999) examined the behavior of banks in 80 mature and emerging markets in the period from 1988 to 1995 to investigate how net interest rate margins (between lending and deposit rates), overhead expenses, taxes paid, and profitability differed between foreign and domestic banks. Foreign banks were found to have higher interest rate margins, profitability, and tax payments than domestic banks in emerging markets, while the opposite was true in mature markets. Moreover, significant foreign bank entry was associated with a reduction in both the profitability and overall expenses of domestic banks. In addition, the efficiency effects of foreign banks on emerging markets banking systems appeared to occur as soon as there was entry and did not depend on gaining a substantial market share.²⁶

On a more regional level, performance indicators for a sample of emerging markets in the more recent period 1996–98 (see Table 6.2) seem to confirm that foreign banks operating in these markets are relatively more efficient than domestic banks. In Central Europe, foreign banks have on average higher returns on average equity, and lower cost-to-income and problem loan ratios, than domestic banks. A similar picture seems to emerge for Latin America, es-

²⁶Studies of the experiences of Argentina (Clarke and others, 1999), Colombia (Barajas, Steiner, and Salazar, 1999), Turkey (Denizer, 1999), and eight Asian economies (Claessens and Glaessner, 1999) also report results that support these conclusions.

Table 6.2. Bank Performance Indicators in Selected Emerging Markets (1996–98)

	Return on Equity		Cost-to-Income Ratio		Problem Loans/ Total Loans	
	Foreign banks ¹	Domestic banks	Foreign banks	Domestic banks	Foreign banks	Domestic banks
Central Europe						
Czech Republic	14.4	-1.6	70.9	40.5	18.8	28.5
Hungary	16.1	-26.0	62.4	113.0	10.6	15.1
Poland	24.1	-0.1	50.9	59.9	11.1	9.2
Total	19.3	-5.0	59.9	62.1	13.7	17.1
Turkey	68.3	29.8	39.0	48.2	6.1	4.1
Latin America						
Argentina	5.8	-0.7	73.4	76.9	5.7	17.3
Brazil	10.4	5.2	73.3	68.8	7.5	7.6
Chile	10.9	14.9	59.8	64.4	1.9	1.5
Colombia	2.7	1.7	70.6	69.1	5.4	6.8
Mexico	-14.3	-2.1	112.3	78.5	4.1	8.7
Peru	14.9	10.8	64.8	80.5	6.0	13.2
Venezuela	40.6	38.2	56.3	64.6	3.9	4.1
Total	6.3	4.7	77.9	71.2	6.1	8.5
Total excluding Brazil and Mexico	9.9	7.5	67.5	71.9	4.5	10.4
Asia						
Korea	-44.2	-20.0	53.7	69.2	15.1	8.6
Malaysia	16.4	7.8	34.7	42.6	6.8	8.4
Thailand	-66.1	-20.2	128.9	72.0	46.2	36.5
Total	-35.7	-14.3	63.8	64.2	19.2	13.8

Source: IMF staff estimates based on data from Fitch IBCA's BankScope Database.

¹Foreign banks are those where foreign institutions own more than 50 percent of total equity (see Table 6.1).

pecially considering the countries that experienced foreign entry early in the sample period (Argentina, Colombia, Peru, and Venezuela). Interestingly, Chile shows indicators that are to some extent more in line with the evidence on mature markets, namely, more profitable local banks. Two factors explain this difference relative to Chile's peer group. First, following a severe banking crisis in the early 1980s, Chile developed one of the strongest and best regulated emerging markets banking systems, and several domestic banks substantially improved their operating efficiency following more than a decade of stable growth while facing foreign competition. Second, the largest foreign banks merged with other local banks in 1996–97, and their performance was initially damaged by the nonrecurring merger-related expenses. In the Asian countries, performance indicators of foreign banks are worse than those of domestically owned

banks, because ownership changes are very recent and previously weak banks were taken over by foreigners.

Further evidence on the beneficial effects of foreign competition is provided by qualitative studies that assess the response of the successful local incumbents. For example, Abut, Bigio, and Siller (1999) held discussions with the senior management of four Latin American banks that were widely regarded as competing successfully with foreign banks.²⁷ It was argued that local banks had to overcome a number of relative disadvantages to compete effectively with foreign banks, including limited access to capital; a lack of geographical diversification in the lending portfolios and sources of funds; lack of experience with multiple markets; delays in and higher costs of implementing new products and services; and limited capacity to afford sizable investments in computer systems and other technolo-

²⁷These banks were Banco Galicia (Argentina), Bradesco (Brazil), Banacci (Mexico), and Credicorp (Peru).

gies. These relative disadvantages had been overcome by developing new sources of international funding (such as by securitization of foreign currency-denominated receivables); the use of international consultants to assess the effectiveness of new products and services that had been developed in different markets; selective associations with foreign and local companies to develop new products; and the formation of alliances with other local banks to develop systems and products jointly in order to obtain economies of scale.²⁸ Moreover, the successful local banks were viewed as building a strong and stable management team that adopted a proactive rather than a reactive strategy for confronting the competition from foreign banks.

There appears to be no well-documented empirical evidence on whether foreign banks ration credit to small firms to a larger extent than domestic banks, but market participants have reportedly noted such behavior in some of the Latin American markets where foreign entry has recently increased. Moreover, bank analysts have argued that the Spanish banks reportedly shelved plans to extend their lending activities to middle-market and retail customers in the period following the recent Brazilian devaluation, citing increased credit risk and the lack of credit histories and transparent balance sheets.

Why is there such a sharp contrast between the effects of foreign bank entry for mature and emerging markets? To a significant degree, the contrasting results reflect differences in initial conditions. All of the recent studies of mature markets cover periods where the banking system regulations and controls have long since been liberalized, and banks faced competition not only from other banks but also from a variety of non-bank sources of credit (especially capital markets). Such competition had already put intense pressures on net interest rate margins and forced banks to merge and/or adopt new technologies to help reduce overhead costs. While foreign

bank entry could intensify these competitive pressures, the scale of such an increase would typically be marginal. In contrast, the studies of the effect of such entry on emerging markets have typically focused on periods where the banking systems have only recently been liberalized and/or were coming out of crisis periods. In either situation, the banks were just emerging from periods where there had often been extensive restriction on new entry (from either new domestic or foreign banks) into the banking system, nonmarket determination of key interest rates (because of either official interest rate ceilings or oligopolistic determination of the interest rate structure by bankers' associations), and limited degrees of competition from nonbank sources of credit. While such an environment increased the franchise value of banks and allowed relatively inefficient banks to survive, these created strong profit opportunities for new banks (whether foreign or domestic) that could operate with more efficient cost structures and offer more market-related interest rates. In this situation, the entry of foreign banks could have a major impact on banking system efficiency both directly because of their own operations and indirectly because they forced other banks to become more efficient if they wished to survive.

Empirical Evidence on the Stability Effects of Foreign Bank Entry

Whatever the effects of foreign bank entry on banking system efficiency, an equally important issue for many emerging markets is whether such banks are likely to contribute to banking system stability and to be a stable source of credit, especially in crisis periods. There are two related issues here: whether the presence of foreign banks makes systemic banking crises more or less likely to occur, and whether there is a tendency for foreign banks to “cut and run” during a crisis.

²⁸It was also noted that local banks have a number of advantages when competing with foreign banks. In particular, these local banks had dominant size and market share in the local market, superior knowledge of the domestic market and its companies, reputation and brand-name recognition, and the ability to react and respond quicker to unexpected events.

Table 6.3. Cross-Border and Foreign Bank Lending in Selected Emerging Markets
(In billions of U.S. dollars)

	Cross-Border Claims of BIS Banks 1996–99 ¹										Total Lending by Domestic and Foreign Banks 1996–98				
	Total			European banks		North American banks		Japanese banks		Other banks		Foreign banks		Domestic Banks	
	1996	1998	1999	1996	1998	1996	1998	1996	1998	1996	1998	1996	1998	1996	1998
Central Europe															
Czech Republic	9.6	12.2	9.9	7.5	10.3	0.0	0.6	1.1	0.6	1.0	0.8	18.4	18.8	12.6	11.2
Hungary	11.7	16.1	14.5	9.0	13.9	0.8	0.7	1.1	0.8	0.8	0.7	5.9	7.8	3.8	3.1
Poland	7.6	14.5	17.2	5.6	10.6	1.0	1.9	0.1	0.3	0.9	1.7	13.0	21.0	13.7	11.7
Total	28.9	42.8	41.7	22.1	34.8	1.7	3.1	2.3	1.6	2.7	3.3	37.3	47.5	30.1	26.0
Turkey	22.6	35.7	34.1	11.8	19.5	2.4	4.7	2.0	2.0	6.4	9.5	0.80	1.2	36.4	46.5
Latin America															
Argentina	44.8	61.5	66.7	23.8	40.3	14.6	14.2	1.8	2.0	4.6	5.0	22.5	30.2	35.8	41.1
Brazil	67.9	73.3	62.3	30.0	43.2	20.6	14.1	5.2	4.2	12.2	11.8	32.8	29.1	209.7	217.5
Chile	15.2	22.2	23.5	7.6	13.9	4.9	5.2	0.8	1.2	1.8	1.9	18.0	23.9	28.9	30.9
Colombia	16.8	17.1	15.8	9.4	9.8	4.5	4.4	1.3	1.5	1.5	1.3	5.4	5.4	24.5	21.6
Mexico	60.1	65.0	63.8	25.1	31.1	20.3	21.4	5.4	4.7	9.4	7.8	12.9	13.3	107.2	98.9
Peru	8.0	10.6	10.9	4.1	7.0	1.5	2.4	0.2	0.1	2.1	1.1	5.5	7.3	5.7	8.2
Venezuela	11.1	12.5	13.2	6.0	7.3	3.2	3.7	0.5	0.4	1.4	1.1	2.8	3.9	5.2	8.0
Total	223.9	262.2	256.2	106.0	152.6	69.6	65.5	15.1	14.1	33.1	30.0	100.0	113.2	417.0	426.1
Asia															
Hong Kong SAR	207.0	131.4	120.9	86.0	74.6	12.1	7.3	87.5	38.7	21.5	10.8	N/A	N/A	N/A	N/A
Korea	100.0	65.3	63.5	33.8	26.2	10.7	7.8	24.3	16.9	31.1	14.4	29.5	12.3	446.9	287.6
Malaysia	22.2	20.8	18.6	9.2	10.6	2.5	1.3	8.2	6.6	2.3	2.3	15.0	13.5	158.7	112.2
Singapore	189.2	125.1	112.6	102.8	75.2	8.8	5.7	58.8	29.5	18.9	14.7	N/A	N/A	N/A	N/A
Thailand	70.1	40.7	34.7	19.1	14.1	6.2	1.9	37.5	22.4	7.3	2.3	13.1	8.5	210.3	129.2
India	16.9	19.3	22.6	7.8	8.9	1.7	2.0	3.5	3.0	3.8	5.5	N/A	N/A	N/A	N/A
Total	605.5	402.7	372.9	258.8	209.5	42.0	26.0	219.9	117.1	84.9	50.1	57.6	34.3	815.9	529.0

Source: BIS, *Consolidated International Banking Statistics*; and staff estimates based on Fitch IBCA's BankScope.

¹Cross-border claims include foreign currency lending to domestic residents without netting residents' foreign currency deposits.

There are surprisingly few studies of the relationship between foreign bank entry and systemic banking crises. However, Levine (1999) has recently attempted to analyze the impact of foreign bank presence on the probability that a banking crisis will occur. Levine's empirical study builds on the earlier work of Demirgüç-Kunt and Detragiache (1998), which used a multivariate logit model to relate the probability that a banking crisis would occur during a particular period to a series of macroeconomic and banking system indicators by adding a measure of the number of foreign banks relative to the total number of banks. The foreign bank share variable was found to have a negative and statistically significant coefficient, which led Levine to conclude,

after controlling for the effects of other factors that are likely to produce banking crises, that greater foreign bank participation was a stabilizing factor.

The stability of foreign bank lending has also been examined by contrasting the behavior of cross-border and local lending²⁹ by foreign banks during crisis periods. For example, it is evident that there were substantial declines in both cross-border and local lending by foreign banks to Asian borrowers during the recent crises (Table 6.3). While cross-border claims declined for all nationalities of banks, the largest declines in lending occurred for Japanese banks. Analysts attribute this sharper decline in lending by Japanese banks to the difficulties faced by these

²⁹Cross-border claims are those booked outside the foreign counterparty's home country, usually at the lender's head office. Local claims on the foreign counterparty are those booked in the local office of the reporting bank, that is, offices located in the country of the counterparty.

banks in their home markets, particularly the need to deal with domestic nonperforming loans and to rebuild capital. Moreover, the cut-back in local lending by foreign banks was only slightly higher (a 40 percent decline) than that for domestic banks (a 35 percent decline).

There is some evidence from the Asian crisis that foreign banks' behavior toward emerging markets is related not just to the inherent risks of their counterparties but also to their long-term commitment to a particular emerging market. For example, Palmer (2000) noted that U.S. money center banks generally sustained the operations of their offshore branches and subsidiaries during the recent emerging market crises. While cross-border claims in Asia decreased 36 percent between June 1997 and June 1999, local claims declined just 6 percent (in Korea, local claims actually rose 19 percent). In addition, U.S. banks' claims on Latin American countries actually increased during that period. Palmer (2000) argued that the disparity between movements in cross-border and local claims reflected the fact that U.S. banks that had developed local franchises in the region saw good prospects beyond the crises, while the extent of franchise development (and the associated commitment) was much less for institutions primarily involved in cross-border lending.

Since much of the increase in foreign banks' entry has occurred only in the latter part of the 1990s, there is only limited evidence on how foreign banks behaved in other crisis periods. In Brazil, for example, cross-border exposures of BIS-reporting banks decreased in the aftermath of the Russia and LTCM crises. During 1996–98, local lending by foreign banks declined while lending by domestic banks increased (see Table 6.3). Foreign lines of credit to Argentina did increase during December 1994 to May 1995, despite the fact that some foreign banks with branches in the country cut off credit lines to their branch operations at the height of the Tequila crisis in February 1995.³⁰ Moreover,

Goldberg, Dages, and Kinney (2000) examined the lending behavior of foreign and domestic banks in Argentina and Mexico in the period surrounding the 1994–95 Mexican crisis and concluded that foreign banks exhibited stronger loan growth compared to all domestic-owned banks, with lower associated volatility, and thereby contributed to greater stability in overall financial system credit. Furthermore, they found strong similarities in the portfolio composition of lending and the volatility of lending by private foreign and domestic banks in Argentina, while the same was true in Mexico for banks with low levels of problem loans. Overall, they argued that bank health, and not ownership, per se, was the critical element in the growth and volatility of bank credit.

In a more recent study of the Asian experience, Laeven (1999) considered the behavior of foreign and domestic banks in East Asia (Indonesia, Korea, Malaysia, the Philippines, and Thailand) in 1992–96 to identify the role of ownership structure in determining vulnerability to domestic and external shocks. In examining both the profitability and risk-taking activities of banks, he found that foreign-owned banks took relatively limited risks and showed an increase in efficiency relative to other banks. In addition, family-owned and company-owned banks were found to hold the most risky portfolios. Moreover, banks that required restructuring after the crisis of 1997 occurred were mostly family owned or company owned and almost never foreign owned.

It is often argued that local operations of foreign banks are likely to have recourse to additional capital from their head offices in times of financial stress. However, this is a largely untested proposition, with only a few clear examples to support it. In Hungary, for example, when the brokerage subsidiaries of foreign banks suffered large losses in the aftermath of the Russian crisis, head offices quickly injected capital.³¹ However, relative to the size of local

³⁰See IMF (1996).

³¹See IMF (1999).

operations, the recapitalizations required were small. In another example of foreign support, Portugal's Banco Espírito Santo injected more capital into its Brazilian subsidiary Banco Boavista Interatlantico, after the latter had to make good on the losses sustained by its mutual funds after the real's devaluation of January 1999. Similarly, Credit Commercial de France injected capital into its Brazilian subsidiary (CCF do Brasil) in 1998 to absorb losses derived from the financial market turbulence of October 1997.³² However, there are also plenty of examples of foreign banks that withdrew from emerging markets after having failed to establish a profitable presence. Market participants suggest foreign banks will likely examine whether or not to inject capital on a case-by-case basis, trading off future value (including international reputational effects) against cost. Minority shareholders are viewed as less likely to make capital injections during periods of financial stress.

Apart from the stability of foreign bank lending, there is also the issue of whether foreign banks can contribute to the stability of the domestic deposit base. Foreign banks can contribute to the stability of the domestic financial system, for example, if depositors shift their funds to foreign institutions that are perceived as sounder than the local banks rather than engaging in capital flight. Flight-to-quality was widespread during the Asian financial crises, as depositors shifted funds from finance companies and small banks toward large banks, especially foreign banks. The market share of deposits in foreign banks tripled in Korea and Indonesia between January 1997 and July 1998, while in Thailand it increased from 2 percent of total deposits to 5 percent in the period December 1996 to December 1997.³³ The crisis that began with the failure of a large bank in Argentina in March 1980 led to runs on three other banks, with for-

eign banks among the beneficiaries of the flight-to-quality.³⁴ Similarly, concerns about the ability of Argentine banks to meet depositor demands following the Mexican crisis of 1995 led depositors to shift their funds to foreign banks;³⁵ however, during more recent crises, deposits remained remarkably stable (see Box 6.4). More recently, rumors of financial difficulties at Postabank—the second-largest retail bank in Hungary—led to a run by depositors that benefited in part foreign institutions.³⁶

In sum, the evidence on the effects of foreign bank entry supports the conclusion that the competitive pressures created by such entry have led to improvements in banking system efficiency in terms of lower operating costs and smaller margins between lending and deposit interest rates. There is as yet only limited evidence as to whether a greater foreign bank presence contributes to a more stable banking system and less volatility in the availability of credit.

Policy Issues

The growing presence of foreign banks has raised a number of complex policy issues, especially in relation to cross-border supervision and regulation, banking system concentration, and systemic risks and official safety nets.

Cross-Border Supervision and Regulation

The growing presence of foreign banks in many emerging market, as well as the expansion of emerging market banks to offshore markets, has increased the complexity of the tasks facing supervisory authorities, especially in emerging markets. Banking supervisors have long been aware of the potential problems associated with the cross-border banking activities, and a series of principles and best practices has evolved to es-

³²See Fitch IBCA (1999b).

³³See Domac and Ferri (1999).

³⁴See Baliño (1991).

³⁵See IMF (1995).

³⁶See OECD (1999).

Box 6.4. Argentina: Foreign Banks and the Resilience of the Deposit Base

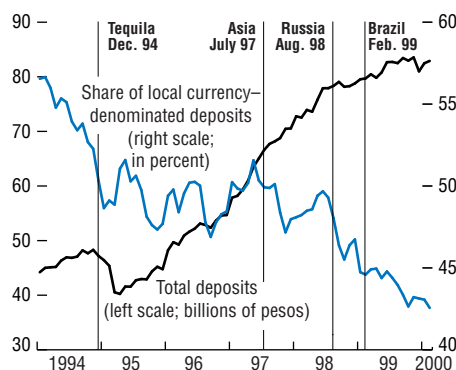
When the Tequila crisis hit Argentina in early 1995, it went hand in hand with massive deposit withdrawals from the banking system. Total deposits declined by about 15 percent (see figure) and there was a (relative) shift of deposits to foreign banks. No such phenomenon was observed in the three subsequent episodes of financial crises. Deposits remained flat or even increased during financial market turbulence in the Asian, Russian, and Brazilian crises, though pressures were felt in interest rates and there was a slight shift from peso to dollar-denominated deposits (see figure).

There are a number of interpretations of this recent stability. First, the central bank is viewed as having gained substantial credibility by having proven its ability to manage a crisis within the limits imposed by the currency board (including by lowering reserve requirements and availing itself of the provision in the Convertibility Law allowing the extension of credit to banks in an emergency). The negotiation in late 1996 of a stand-by repo facility with international banks further added to the ability of the currency board system to create emergency liquidity. This in turn led to greater stability of deposits in the ensuing emerging market crises.

Second, observers have pointed to improved confidence in the banking sector. Given the limited lender-of-last-resort functions under the currency board arrangements, reforms undertaken during 1991–94 had already emphasized improving liquidity and capitalization as well as transparency at the individual bank level.¹ The second generation of reforms in the wake of the Tequila crisis focused on consolidating and deepening these reforms, including through the introduction of a remunerated liquidity requirement and the development of a so-called BASIC

¹See Dziobek, Hobbs, and Marston (2000).

Argentina: Total Deposits and Their Composition



system of banking oversight, which emphasizes the monitoring and discipline imposed by the market (including through increased transparency in reporting and the mandatory use of credit ratings).² These measures were accompanied with the development of a privately funded limited deposit insurance for small depositors in April 1995, further enhancing confidence in the system.

Third, analysts have mentioned the growing presence of foreign banks (foreign banks are currently part owners in all the 10 largest private banks) as another source of stability of the deposit base. Indeed, in each of the contagious currency crisis episodes, there was flight-to-quality, from small banks to large and foreign banks, in part based on the perception that the latter would be supported by their parent institutions. This flight-to-quality, in turn, contributed to the ongoing consolidation and the increasing share of foreign ownership in the banking system.

²See IMF (1998a), p. 161.

establish effective prudential supervision of these activities (Box 6.5). The key objective of the supervisors of internationally active banks has remained that of ensuring that no activity of these

banks escapes effective supervision and that coordinated remedial action can be undertaken when necessary. Nonetheless, the collapse of institutions such as BCCI in 1991 (see Box 6.6)

Box 6.5. Cross-Border Supervision: Principles and Current Practices

Since the mid-1970s, the Basel Committee on Banking Supervision has developed a series of principles and standards for effective supervision of cross-border banking activities. The initial Basel “Concordat” in 1975 placed primary responsibility for the supervision of cross-border banks with the host supervisor.¹ In matters related to solvency, the host authority would have primary responsibility for foreign subsidiaries and joint ventures, whereas the home supervisory was responsible for branches. In 1983, the Concordat was revised to introduce the principle of consolidated supervision and to make the solvency of foreign subsidiaries the joint responsibility of the host and home authorities.²

Following the failure of BCCI (see Box 6.6), the committee issued in 1992 four minimum standards for the supervision of cross-border banking. These were that:

1. All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision.
2. The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank’s (or banking group’s) home-country supervisory authority.
3. Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks for which they are the home-country supervisor.
4. If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

Subsequently, a working group of the Basel Committee and the Offshore group of Banking

Supervisors issued a set of recommendations to supplement the four minimum standards.³

The standards and recommendations mentioned above have led to a set of practices designed to produce effective supervision of cross-border banking activities.⁴ The licensing of cross-border banks should require the informed and explicit consent of both the host and home country authorities. In addition to applying normal licensing procedures, both authorities should also consider the strength of the bank’s and banking group’s capital and procedures for the management of risks, both on a local and consolidated basis. Moreover, the host country authority should evaluate the level of support that the parent is capable of providing to the proposed establishment.

The home country supervisory authority has responsibility for the consolidated supervision of the bank or banking group on a global basis. Host countries are primarily responsible for the liquidity of a foreign bank, since they have a better understanding of local money market conditions and practices. Moreover, the host authorities are also responsible for the solvency and supervision of foreign subsidiaries. Despite this division of responsibilities, the home and host authorities need to be in close contact and cooperate effectively.

The exercise of effective global consolidated supervision requires a regular flow of verifiable financial and prudential information from the local banking establishment to the home country supervisor. This information should encompass both quantitative and qualitative data needed for the proper exercise of supervision. Quantitative information would include such information as to allow the supervisors to calculate the bank’s (or banking group’s) capital adequacy position, large exposures or legal lending limits, and funding and deposit concentrations. Together with free flow of data, the host author-

³See Basel Committee on Banking Supervision (1996).

⁴Chapter VIII of IMF (1998b) provides a detailed discussion of the evolution of best practices in cross-border supervision.

¹See BIS (1975).

²See BIS (1983).

ities should permit on-site inspections by the home supervisor. Similarly, there needs to be an adequate flow of information from the home to the host supervisor. Information on substantial changes in strategy, ownership, financial situation, or any problems in establishments abroad, the head office, or the parent banks should be communicated immediately to the other supervisory authorities involved.

The home supervisory authority has a responsibility to safeguard the domestic financial system by preventing the establishment of un- or undersupervised foreign banking establishments in its jurisdiction. In this regard, the host has to determine whether the bank or banking group is subject to consolidated home supervision and whether the home supervisor has the capacity to perform such supervision. If the standards discussed above are not met and the home country authorities are unwilling or unable to take measures to ensure that these standards are met, then the host country authorities should prevent the creation in its jurisdiction of any cross-border establishments by that bank or banking group.

Special problems can be posed by so-called shell banks—licensed or registered in one center but effectively controlled or managed from another jurisdiction—and parallel-owned banks—where a bank in one jurisdiction is under the same nonbank ownership as a bank in another jurisdiction. To be effective, no shell bank should be licensed if the head office is not subject to effective supervision on a consolidated basis. If the nonbank owner has as its sole activity ownership of one or more banks, the owner ought to be subject to consolidated supervision. In the absence of such arrangements, the respective supervisors will have to prevent sources of contagion, for example by limitations on connected lending.

Finally, the lengthy liquidation of BCCI and its subsidiaries, has highlighted the importance of cooperation among supervisors of different jurisdictions, as well as the desirability of further harmonization of insolvency rules for financial institutions.⁵

⁵See IMF (1998b).

and Peregrine Investments in 1998³⁷ has illustrated how a constantly evolving set of institutional structures and legal arrangements could potentially be used to escape effective prudential supervision. Moreover, the recent experience of the Bank of New York has demonstrated how readily cross-border banking linkages can be used for purposes of fraud and money laundering. Indeed, one of the ongoing concerns of bank analysts and supervisory authorities is that the increasing complexity of cross-border banking activities and institutional arrangements will allow some activities to “fall between the cracks.”

From the perspective of emerging market banking supervisors, there are a number of is-

issues that have become increasingly important as the presence of foreign banks has expanded. First, there is the issue of how to monitor the local establishments of large international and regional banks. As foreign banks become an important source of financial services, emerging market supervisors need to be aware of the financial positions of not only the local branches and subsidiaries of major international and regional banks but also the parent bank. Indeed, difficulties at the parent bank could raise questions about the survivability of the local affiliate, even if its position is fundamentally sound. Second, one of the key strategies employed by major international banks to gain market share

³⁷Peregrine had grown to become Asia’s largest investment bank outside Japan before its collapse in January 1998. It was not registered or regulated as an investment bank, but was in fact structured as a group with some 200 subsidiaries, of which many were special purpose vehicles registered offshore (see IMF, 1998a).

Box 6.6. Bank of Credit and Commerce International

The case of the Bank of Credit and Commerce International (BCCI) provides an example of how various cross-border banking institutions and arrangements can be used to evade effective prudential supervision. BCCI was closed on July 5, 1991. The bank's liquidation was the result of a concerted action by regulators from around the world, motivated by evidence of widespread fraud as well as the fear that the financially troubled institution would siphon off deposits from host-country branches. In the resolution of BCCI, depositors and creditors in 73 countries eventually received about 70 cents on the dollar.

BCCI had a complex ownership structure. The parent company, BCCI Holdings, was incorporated in Luxemburg and had two main bank subsidiaries: BCCI S.A. Luxemburg and BCCI (Overseas) Ltd. in the Cayman Islands. The United Kingdom was the home of its operations center. Through "front men" BCCI also secretly and illegally controlled a number of U.S. banks and other banks worldwide.

Analysts have said that one cannot hope to understand BCCI by thinking of it as a standard bank. BCCI was not in the traditional business of banking. On paper, BCCI was owned by a number of wealthy individuals. However, in reality BCCI never had much capital; it manufactured capital "out of thin air" by providing loans

to individuals with which to buy BCCI shares. Much of the Bank's business centered on illegal activities outside the reach of banking supervisors, such as money laundering, capital flight, and smuggling. Finally, it assisted governments in covert military operations, as in Afghanistan and in the Iran-contra affair. The bank thrived by taking deposits, and its deposit base grew exponentially, especially in developing countries, to reach \$20 billion before concerns surfaced. This allowed the bank to continue operations without capital.

BCCI was notoriously difficult to supervise. The licensing authorities for the two parent banks could only supervise a very minor part of the group's activities, as the bulk was conducted in jurisdictions different from their own. As regulators learned about losses incurred in 1985 in BCCI's treasury operations, they at first sought to protect depositors by securing financial and managerial support of the majority shareholders. However, when a 1991 audit by Price Waterhouse commissioned by the Bank of England showed that BCCI had been involved in fraudulently covering up its losses—by not recording some \$600 million in deposits as well as by extending loans through "special duty accounts" to cover interest payments and lend the illusion that nonperforming loans were actually performing—regulators moved to shut down the bank.

when they enter an emerging market is to offer a variety of new financial products, including OTC derivative products. While these new derivative products can allow for better hedging of a variety of risks, experience has shown that they can be readily used to evade prudential regulations. As a result, emerging markets' supervisors will need to upgrade their ability to analyze the growing use of these instruments. A third issue is understanding when and to what extent parent banking organizations will support their local operations in times of difficulty or crisis. Finally, the expansion of large banks into emerging markets can raise issues related to the concentration

in the local banking industry, especially if this creates banks that are regarded as "too big to fail."

Large Complex Banking Organizations

The ongoing consolidation of the global bank industry has created a set of large international and regional banks that engage in a broad range of complex on- and off-balance-sheet transactions and their total assets are multiples of most emerging markets' GDPs. These institutions are typically the parents of the foreign branches and subsidiaries established in most emerging markets. Understanding and supervising

ing the exposure of these large international organizations has led to special measures by mature markets' supervisors and requires a level of financial expertise that may be lacking in many emerging markets. For instance, supervisors in the United States have selected a small subset of large, complex, banking organizations (LCBOs) and have established teams of examiners—assisted by specialists in payments systems, risk management, information technology, financial engineering, and modeling—that are dedicated to monitor each one of these LCBOs.³⁸ Since difficulties at one of these parent organizations could quickly create doubts about the viability of its local branches and subsidiaries, the stability of emerging market financial systems has become increasingly dependent on the quality of prudential supervision in the mature markets. Nonetheless, emerging market supervisors will still need to develop the expertise to monitor a new range of activities and instruments that are likely to be used by the local establishments of LCBOs. The need to acquire such expertise has been demonstrated by the role that derivative products have played in recent balance of payments crises.

Derivative Products and Prudential Supervision

As noted earlier, one of the strategies employed by major international banks when they enter an emerging market is to offer a variety of new products, including OTC derivative products. These new derivative products can be a source of considerable benefit since they increase the ability to separate and market risks and thereby allow for better hedging of a variety of risks that were previously undiversifiable. However, as noted by Garber (2000), these instruments can also be used to take on excessive risks, especially in weak financial systems with obsolete accounting systems, slow reporting sys-

tems, and unprepared supervisors. Moreover, derivatives can both affect balance of payments dynamics during a crisis period and can be used to evade prudential regulation and capital or exchange controls.

The use of OTC derivative products have had an important influence on balance of payments dynamics in several emerging market balance of payments crises of the 1990s in countries such as Mexico, Korea, Brazil, and Russia.³⁹ For example, a strategy used by some Korean banks in 1996–97 was to acquire structured notes that involved taking leveraged positions on currencies. In some cases, banks bought notes tied to movements to the Indonesian rupiah.⁴⁰ Korean banks that were attempting to rebuild capital positions were attracted to such notes by the seemingly high returns in a stable rupiah exchange rate environment. When the rupiah depreciated sharply, Korean banks took a double hit: they saw the U.S. dollar value of the capital of the structured note decline and they had to deliver U.S. dollars to meet margin requirements or to wind up their repurchase agreements. Such pressures intensified during December 1997 and contributed to the sudden drain of official reserves. While most of these notes were obtained through offshore transactions, a local presence by a foreign bank providing such instruments would only facilitate the marketing process.

Structured notes, equity swaps, credit derivatives, and other derivative instruments can also be used to evade the intent, if not the letter, of prudential regulations such as those designed to limit net foreign currency exposures, limits on large exposures to single borrowers, and reserve and liquidity requirements against domestic and foreign currency liabilities. At times, this will involve booking the principal as a foreign currency asset (such as U.S. dollars) but structuring the financing of and ultimate return on the in-

³⁸See Meyer (1999).

³⁹See Garber (2000) for a detailed discussion of the types of instruments that were used.

⁴⁰The note would pay a high coupon, but the principal repayment would depend on the U.S. dollar-rupiah exchange rate—if the rupiah depreciated, the principal repayment and interest coupon would be reduced. These positions were often leveraged by having the foreign seller of the notes enter into a repurchase agreement with the buyer with a 20 percent margin requirement.

strument so that it becomes a foreign currency liability.⁴¹

It is evident from the experience of the 1990s that the supervisory authorities in emerging markets will need to upgrade their capacity to acquire information on and to analyze the implications of the growing use of derivative products by domestic and foreign banks operating in their markets. This will be especially true in those situations where new foreign banks are attempting to establish their position in the local markets through the marketing of these instruments and where some domestic banks are still in a weakened financial position.

Parental Support

A key consideration influencing the decisions of both the authorities to allow foreign banks to enter and local residents to place deposit in these banks is the extent of the support that these banks are likely to receive from their parents. There are both legal and reputational issues involved in determining the support that is likely to be forthcoming during difficult periods. From a narrow legal perspective, a bank subsidiary is a stand-alone entity with its own dedicated capital, and the parent's formal obligation to support its subsidiary is generally limited to the amount of invested capital. However, the relationship between a bank and its subsidiary can be broader as a result of statutes (U.S. law, for example, requires banks to guarantee their subsidiaries' capital) or from contractual provisions between a bank and its subsidiary (that may be imposed by the regulatory authorities as a condition for issuing a license to a subsidiary). In contrast, a branch has no independent legal personality distinct from that of its parent, and claims on the branch actually constitute claims on the parent.⁴² Even apart from the legal requirements, a parent bank would typically have an incentive to support its local branches and sub-

sidaries because of the reputational effects associated with allowing their failure and collapse. Indeed, the failure of a large branch or subsidiary in one country could call into question the parent's support for its establishments in other countries or even the strength of the parent's own financial position.

A number of factors are likely to influence both the likelihood and extent of a parent bank's support for its foreign establishments. One key factor is the financial position of the parent bank. A parent bank under profit pressure and with a weak capital position may have little capacity to raise the funds needed to recapitalize a large troubled foreign entity. Another important factor is the degree to which the parent bank is committed to developing a sustained presence in the local market. As noted earlier, some foreign banks enter a market primarily to service customers from their home market that have set up operations in the local market. Should those customers fail or leave the market, these banks would be less inclined to maintain a local presence. Another issue is likely the degree to which the difficulties encountered by the local establishment have arisen as a result of its own actions (such as having inadequate controls against fraud) or are due to events beyond its control (such as the imposition of capital controls or the expropriation of its assets). While the parent bank will typically have a strong incentive to remedy problems created by weak internal controls, it may have a much smaller incentive to support its local establishment if *force majeure* events prevent the local entity from making payments.

It is evident from recent episodes of "ring-fencing" of the obligations of the local branches of some major international banks in Asia that there are clear limits on the extent of parental support for these local operations. The ring-fencing banks argue that the imposition of controls on capital outflows by Malaysia led to inter-

⁴¹Garber (2000) describes in detail the so-called Tesobono swap, which allowed Mexican banks to essentially convert a reported U.S. dollar asset into an obligation to deliver U.S. dollar payments if the Mexican peso depreciated relative to the U.S. dollar.

⁴²See IMF (1998b), p. 51.

nal reviews of what similar controls in other countries might do to the ability of their branches to make payments on foreign exchange-related transactions. They found that under some agreements, such as the master ISDA netting agreements for derivative products, the parent would be responsible for completing the transaction if its onshore branch could not make payment. In their view, the parent was therefore implicitly providing its counterparts with insurance against sovereign events such as the imposition of capital controls. To correct this situation, they inserted the ring-fencing clauses into their confirmation documentation to spell out the conditions under which the parent would not be responsible for the payments of the onshore branch and to make the pricing of these transactions more transparent.

Other banks have argued that ring-fencing is not just a pricing issue but has broader systemic implications because it will alter the degree of support that parent banks will offer their onshore branches and subsidiaries during crisis periods. These bankers made two points. First, the recent ring-fencing clauses were quietly inserted into the confirmation sheets without any prior announcement and this could be done in the documentation governing other cross-border products. Second, the ring-fencing clauses change not only the credit risks associated with these contracts, but also the jurisdiction in which they can be enforced. While the master ISDA agreements are enforceable in mature market courts (typically in the United States or the United Kingdom), the ring-fencing clauses mean that any claims on a ring-fenced branch would most likely have to be litigated in the local courts.

While this ring-fencing activity applies to derivative products contracts and were initiated by

the banks, other obligations of branches are in some cases ring-fenced by law. For example, under the Federal Reserve Act and also New York banking law, all deposit liabilities of the foreign branches of U.S. banks are already ring-fenced if the local authorities take actions that prevent the local branch from making payment (such as the imposition of capital controls).⁴³ This policy was apparently motivated by earlier experiences when the branches of some U.S. banks were unable to make payments on maturing deposits due to the imposition of capital controls or expropriation (in Cuba and Vietnam).

Banking System Concentration

The expansion of large foreign banks (often with global balance sheets several times local GDP) into emerging markets has prompted concerns about concentration in the local banking markets. The entry of such institutions can affect banking system concentration both directly and indirectly. In some cases, large foreign banks have acquired a significant share of local bank assets by purchasing a local state bank that was being privatized or by acquisition of a large private bank that was in need of recapitalization. The entry of such banks would in turn create pressures on local banks to merge to remain competitive both by capturing economies of scale in back-office operations and by being viewed by depositors as offering the same degree of safety and soundness as large foreign banks. Moreover, in some countries, such as Chile, the concentration issue arose when the parents of two local foreign banks merged.⁴⁴

There are concerns that such concentration could create monopoly power that would reduce banking system efficiency and the availability of

⁴³The relevant Federal Reserve statute states “a member bank shall not be required to pay any deposit made at a foreign branch of the bank if the bank cannot repay the deposit due to (1) an act of war, insurrection or civil strife; or (2) an action by a foreign government or instrumentality (whether de jure or de facto) in the country in which the bank is located unless the member bank expressly agreed in writing to repay the deposit under those circumstances.”

⁴⁴The merger of Banco Santander with Banco Central Hispano resulted in the joint majority ownership by BSCH of their respective subsidiaries, Banco Santander Chile and Banco Santiago, the two largest banks in the country with a combined market share of about 28 percent of total deposits. However, both institutions have kept their brand names and separate management teams.

Table 6.4. Assets of Largest Foreign Banks in Central Europe and Latin America

	Total Assets of Parent Bank ¹	Total Assets of Parent Bank in the Region ²	Assets of Parent Bank in the Region	
			(Percent of total assets in the region)	(Percent of total assets of parent bank)
	<i>(In billions of U.S. dollars)</i>			
Central Europe				
Erste Bank der Oesterreichischen Sparkassen AG ³	60.7	15.0	7.8	24.7
KBC Bank NV	163.1	8.2	4.3	5.0
Bank Austria AG	139.7	7.2	3.7	5.1
ING Group	460.8	4.3	2.2	0.9
Latin America				
Banco Santander Central Hispano	271.1	43.8 ⁴	3.4	16.2
Banco Bilbao Vizcaya, BBV ⁵	164.3	35.3	2.7	21.5
Fleet Boston Financial Corporation	190.7	27.3	2.1	14.3
Citigroup	668.6	26.1	2.0	3.9
HSBC Holdings Plc	475.5	16.7	1.3	3.5

Source: IMF staff estimates based on data from Fitch IBCA's BankScope Database.

¹Consolidated balance sheet of parent bank.

²Based on the same data and assumptions as Table 6.1.

³Including Ceska Sporitelna.

⁴Excludes acquisitions of Meridional-Bozano Simonsen in Brazil and Serfin in Mexico.

⁵Before merger with Argentaria.

credit, open up new avenues for the transmission of disturbances from mature to emerging markets, and increase the risk that these institutions will become too big to fail locally. It has been argued that a high degree of banking system concentration will adversely affect output and growth by yielding both higher interest rate spreads (with higher loan rate and lower deposit rates) and a lower stock of credit than in a less concentrated, more competitive system. However, there are conflicting theoretical views on the effects of such concentration on growth and output, and the limited empirical evidence yields conflicting results.⁴⁵ In any event, the recent experiences of Chile and Mexico suggest that emerging markets should equip themselves with antitrust laws appropriate to deal with the complex issues involved in the definition and resolution of anticompetitive cases in the financial sector.

Even if there is ambiguity about the effects of banking system concentration on economic per-

formance, it is evident that a highly concentrated system could face a too-big-to-fail dilemma. In this situation, the failure of a single large bank could seriously disrupt the local payments system and money markets. Moreover, when the largest banks consist of foreign banks, then a high degree of concentration can open up a new channel for the transmission of shocks in the sense that difficulties for the parent bank can create immediate uncertainties about its local branches and subsidiaries. The potential magnitude of these shocks could be gauged from Table 6.4. Some foreign banks own more than 3 percent of assets in either Central Europe or Latin America. More important, in some cases their presence exceeds 10–20 percent of the assets of a country's banking system. Also, the share of total assets held by some of the international banks in Central Europe and Latin America is around the 15–25 percent level, suggesting fairly large exposures to relatively volatile regions.

⁴⁵For example, Levine (2000) found no statistical relationship between banking system concentration and any negative outcomes for financial sector development, banking system fragility, or growth. In contrast Cetorelli and Gambera (1999) found that, while banking system concentration helps those industries heavily dependent on external financing, the overall effect on output was negative.

Systemic Risk, Official Safety Nets, and Cross-Border Banking

Systemic risk associated with cross-border banking can arise if either liquidity or solvency problems of banks in one country create similar problems for financial institutions elsewhere in the international financial system. As noted by Berger and others (2000), the contagion effects associated with such problems can be transferred across different financial systems through failures to settle in payments systems, panic runs that follow the revelation of institutional problems, or falling prices, liquidity problems, or markets failing to clear when large volumes are traded under crisis conditions. In addition to creating problems for the implementation of monetary policy, such contagion will also impose the costs arising from the bankruptcy and financial distress of institutions affected by the contagion.

Systemic risk can conceptually either decrease or increase as a result of a growing foreign presence in the banking system. As noted earlier, foreign bank entry is likely to lead to consolidation in the banking system both directly (if foreign banks acquire local banks) and indirectly (as competitive pressures lead local banks to merge). This consolidation may help reduce systemic risks if it creates a smaller set of larger institutions that are more efficient and can be monitored more readily by prudential supervisors and market participants. In addition, the large foreign banks would be part of institutions that have business activities diversified across national borders and can potentially be a source of support for their local bank. On the other hand, systemic risks could rise because the failure of larger institutions can be more severe. In addition, a weakened parent bank could quickly drain funds from a local bank to support its own position.

Cross-border banking activities can affect the cost of maintaining an official safety net under the financial system in a number of ways. If governments are more likely to protect large banks because they are regarded as “too big to fail,” then the mergers stimulated by foreign bank

entry could increase the implicit costs associated with maintaining the official safety net. To contain these costs, there will be a need to strengthen prudential supervision of such institutions or eventually to limit mergers that increase systemic risks sharply. Moreover, the entry of foreign banks and associated local mergers could bring into the official safety net institutions that normally receive only limited access to the safety net. In many emerging markets, banks are not stand-alone institutions but are rather a part of holding company groups. Even when banks are of a relatively modest size, the existence of these groups raises issues about what level of consolidation should occur when evaluating bank capital adequacy. The key issues are that the holding company can potentially transfer capital and asset and liability positions among its various entities if they are not treated on a consolidated basis and that there will not be arm’s-length transactions between the various members of the group. As the banks owned by the groups become too large to fail, there is the concern that support provided to the bank during a crisis period will either directly or indirectly assist the rest of the group. In many respects, these potential problems can only be minimized by consolidation at the group level.

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